Nos. 226, 227, 243, 266

In the Supreme Court of the United States

OCTOBER TERM, 1948

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CENTRAL-ILLINOIS SECURITIES CORPORATION, C. A. JOHNSON, LUCILLE WHITE AND FRANCIS BOEHM

THOMAS W. STREETER ET AL., PETITIONERS

v.

CENTRAL-ILLINOIS SECURITIES CORPORATION, C. A. JOHNSON, LUCILLE WHITE AND FRANCIS BOEHM

THE HOME INSURANCE COMPANY AND TRADESMANS NATIONAL BANK AND TRUST COMPANY, PETITIONERS

v.

CENTRAL-ILLINOIS SECURITIES CORPORATION, C. A. JOHNSON, LUCILLE WHITE AND FRANCIS BOEHM

CENTRAL-ILLINOIS SECURITIES CORPORATION AND CHRISTIAN A. JOHNSON, PETITIONERS

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Central Illinois argues that "the District Court was not required to disturb, and did not disturb, any

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[1] Pursuant to stipulation the briefs of petitioners in Numbers 226, 227, 243, and 266 were exchanged simultaneously. These briefs set forth the arguments of the Commission, of

factual finding of the Commission" (p. 125); that its "disagreement * * * with the Commission was basically a disagreement as to applicable legal principles" (p. 16); and that because the district court properly held as a matter of law $100 a share to be the proper payment to each series of the preferred, there should be no remand to the Commission as required by the decision of the Court of Appeals. Nevertheless, Central Illinois' brief makes no effort to support the legal theory of the district court that, under the *Otis* case, "standards" or "notions" of colloquial equity, rather than strict priorities should determine a proper allocation;[2] does not dispute that the doctrine of the strict priorities ap-

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the preferred stockholders and of the Central-Illinois group of common stockholders, in respect to both the petitions and cross petitions. The other group of common stockholders, Lucille White and Francis Boehm, respondents in Numbers 226, 227, and 243 did not file a cross petition. We do not anticipate receiving their brief in time to reply herein to any of their arguments, which may differ from those already stated in the brief filed on behalf of Central Illinois.

[2] Central Illinois insinuates that the Commission and the preferred stockholders invented the term as a derogatory epithet, referring (p. 107n) to the "derisive statements of petitioners in the Court below that the District Court has sought to substitute 'notions of colloquial equity' for the strict priority standard,"; Cf. Central Illinois' statement (p. 17) that the "District Judge ascertained a number of factors * * * corroborative of his view that payment of the premiums to the preferred would result in unfairness and inequity in a 'colloquial' sense, as well as in its technical statutory sense;". That the District Judge himself characterized his approach as one of colloquial equity and did so in all seriousness is shown by the quotations from his views in our main brief (pp. 14–15, 53, 71–72).

plies in Section 11 (e) reorganizations and in fact relies upon that principle (Point V, p. 106); does not repeat its earlier argument to the effect that, if the entire bundle of preferred stockholders' preferential rights could properly be valued at any amount in excess of the involuntary liquidation preference, the excess is entitled to only such recognition as may commend itself to the chancellor's discretion;[3] makes virtually no effort to support the theory of the court of appeals that in determining equitable equivalent "ex the Act" the Commission should value on the basis of a balance sheet reconstituted as if the Act had never been passed and with past losses returned to the credit of the enterprise;[4] and develops as its main argument a thesis which both courts below declined to adopt—that, despite the *Otis* case, the preferred stockholders' liquidation preferences are dispositive.[5]

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[3] See I B of our main brief, pp. 28–34, and especially p. 29, n. 18 quoting from Central Illinois' former position.

[4] See our main brief, Point I E, pp. 46–75, and compare the statement in Central Illinois' brief in opposition (Point III, p. 34) that the Court of Appeals had not intended the Commission on remand to make a "precise computation" of such losses, but merely to give "reasonable consideration to the fact that such losses * * * had been sustained."

[5] An appeal to fireside equities is interwoven with other arguments apparently by way of color and not as any overt formulation of a standard which by itself should furnish a guide to either court or Commission. Because of the factual distortions involved in this indirect argument of colloquial equities we note below our disagreement with numerous parenthetical observations of this character.

In support of this basic legal argument, and in support of the court of appeal's criticism of the Commission for failure to forecast future earnings accruing to the common stock if Engineers continued, Central Illinois advances two interrelated economic arguments. First, it is asserted that because of the alleged economic advantages of retaining Virginia, Gulf and El Paso under a holding company, and because of the leverage advantage to the common stockholders of renting the preferred stockholders capital at an average cost of 5.4%, or perhaps less, something of value disappeared in the liquidation of the holding company for which common stockholders should be compensated before the preferred get more than their liquidation preferences. The second economic argument is that the preferred stocks, if valued on a going concern basis, should not have been valued in relation to the then current yield of investments of comparable risk but that such a "transient market value" should have been rejected by the Commission for a "long term" or "average" value.

We deal first with Central Illinois' economic arguments.

I. REPLY TO THE ARGUMENT THAT VALUE DISAPPEARED IN THE LIQUIDATION OF ENGINEERS UNDER THE PLAN

Central Illinois argues (p. 116, n. 1) that the common stockholders sustained through the plan "deprivations attendant upon entirely giving up the holding company form of organization, the

financial advantage of filing consolidated tax returns. * * * the centralized expert service organization, the leveraged capital structure and the recoupment of past losses which such structure would produce in an economic upswing.".

Similar assertions occur throughout its brief. See, for example, the statement (p. 13) that the Commission made no effort to determine "what each class of security holders was losing by the liquidation;" its reference (p. 18) to "further deprivations incident to the liquidation [that] would necessarily fall on the common stockholders (R. 307a–308a)";[6] the reference (p. 114) to the fallacy of the Commission's "implicit assumption that if the preferred stockholders sustained a deprivation" from the retirement of the preferred "the common stockholders necessarily became the beneficiaries of that deprivation." Indeed, this is the major thesis of Point VI (pp. 114–123) of Central Illinois' argument.

A. LEVERAGE

In developing this argument Central Illinois mainly stresses loss of leverage. The term "leverage" is used to illustrate the advantage which results to owners of a junior investment if the earnings upon the total capital invested in the enterprise are at a higher rate than the interest cost

[6] The record referen[illegible] is to the district court's findings concerning losses to common stockholders prior to the plan.

or preferred dividend cost of obtaining senior capital.[7] Central Illinois purports to demonstrate this advantage mathematically by pointing out that apart from the liquidation required by Section 11 the common stockholders could continue to use $39,000,000 of preferred stockholders' capital at an average rental charge of 5.40%, on the basis of existing dividend preferences, or, through refunding, on the basis indicated by the Badger testimony, at only 4.6% It is asserted that, on the other hand, the common stockholders could have obtained a return of 12½% from the use of these funds. From this it is argued that value, to the common stockholders at least, disappeared in the liquidation of Engineers in an amount at least equal to the return obtained from paying in the neighborhood of 5% for senior capital and realizing 12½% from its use (Central-Illinois brief, pp. 117–118). Apart from the element of exaggeration in the hypothesis of a current 12½% return,[8] the argument involves the

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[7] A related aspect of leverage involves, of course, magnification in its impact upon the junior security holder of any rise or decline in the value of the total capital at stake.

[8] The eight times earnings figures used by Central-Illinois represent the ratio between market prices of El Paso, Gulf States, and Virginia on August 1, 1947 and estimated earnings for those companies. It should be noted that the average "yield" based upon current dividend rates of those companies is 6.96%. Central Illinois also refers to the Public Utilities Fortnightly issue of December 2, 1948 for a "list" of stocks purchasable at eight times earnings. That list discloses average yields of 7.1% for one group and

obvious fallacy of ignoring what the common stockholders would have been required to risk by keeping the Engineers preferred stocks outstanding.

Central Illinois argues elsewhere that the risk of Engineers not earning enough to cover even the preferred dividends were such as to make it proper to characterize the preferred as a "low grade" investment rather than "medium" (Brief 12–13, 76. See our main brief p. 8).[9] Regardless of the proper characterization, the testimony that a willing buyer and a willing seller would value the preferreds on a 4.6% yield basis, as compared to yields of less than 3% on high grade long term

6.1% for the other group of stocks. The average price-earnings ratio is not eight times but 13 times for one group and 10.3 times for the other group.

[9] Actually, Badger's characterization as "medium" was in comparison to operating company preferreds which he regarded as medium grade from the point of view of earnings and asset coverages. Barnes' characterization as "low grade," and nearer to a common stock in quality, was by comparison with operating company stocks. In a further attempt to undermine the Commission's findings of fact, despite the concession that the District Judge did not disturb them, Central Illinois (pp. 12–13) refers to the Standard & Poor's rating for Engineers preferred. This rating was as of September 11, 1944, shortly prior to the abandonment of such quality ratings for preferred stocks as "meaningless." The service continued, however, to give ratings from the point of view of over 'l desirability of the investment, and characterized the Engineers preferred as "Ab–A" which means above average and is, therefore, a high rating from the point of view of desirability. See R. 1844a, 2120a.

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bonds, is recognition of a substantial risk factor. Any decline in earnings which would prevent full payment of the preferred dividend would, of course, stop common dividends altogether. If the common stockholders had been free to retain the preferred stock in the picture—and had elected to do so—they would have been required to leave as security for the preferred stockholders' prior claim all but the amount of the distributable earned surplus, instead of withdrawing therefrom the valuable equity which they received under the plan when they acquired direct ownership of the operating company common stocks. Thus common stockholders, in addition to paying the "rent" for the preferred stockholders $39,000,000 of senior capital, would have been required, had Engineers not been liquidated, to continue to risk as security for the preferred stockholders' prior claim a junior equity having a much larger market value, as indicated by Central Illinois' own figures of the market value as of the date of distribution of what they received under the plan (pp. 101–102): $88,768,149 less the $22,000,000 paid in the exercise of the Gulf Warrants or a net of $66,768,148 or $34.96 per share.[10]

A great deal was heard of the advantages of

[10] The value which common stockholders would have been required to leave in was $66,768,149 less whatever amount the common stockholders might have withdrawn in dividends, which obviously was not the full amount of the consolidated earned surplus in view of subsidiary dividend freezes. Possibly, not even the amount of the unrestricted surplus could

"leverage" in the lush days of holding company promotions, but the fact that leverage works both ways was dramatically illustrated in the collapse of market quotations for holding company common stocks which preceded the passage of the Act. See Hearings Before Committee on Interstate and Foreign Commerce on H. R. 5423, 74th Cong., 1st Sess. (1935) at p. 2090. Engineers' common stockholders have had their own dramatic experience with the disadvantage of leverage in declining markets, or in the event of other unfavorable developments. The common sold as low as 1⅛ in 1935 and again as recently as 1942 at a low of 1¼, as compared with 36 on February 13, 1946 (R. 63a) and the $34.96 market valuation of what was received under the plan.[11]

Congress has concluded that the extreme leverage which results from introducing senior securities at the holding company level—in addition to such stratification as occurs at the operating company level—is unsound and involves undue speculation from the point of view of the holding company common stockholders as well as other security holders.[12] We submit that the Commis-

have been withdrawn in view of pressure to provide for the expanding plant requirements of subsidiaries and the possible reluctance of large common stockholders to realize income taxable as dividends rather than as capital gain (see our main brief, p. 73).

[11] See *supra*, p. 8. See also the chart of common stock fluctuations since 1930 (R. 1361a).

[12] S. Rep. No. 621, 74th Cong., 1st Sess., p. 4; H. Rep. No. 1318, 74th Cong., 1st Sess., p. 2.

sion was entitled to follow the legislative judgment to the extent of concluding that in giving up the rental of the preferred stockholders' senior capital, whether at the rate of 5.4% or 4.6% per annum, Engineers' common stockholders did not give up a value disproportionate to the risk from which they were thereby relieved, and that despite loss of leverage the common stockholders benefited from the plan.[13] Stated in different terms, since the common stockholders had more capital at risk than the preferred, there is no basis for concluding, so far as the leverage element is concerned, that money spent by the common stockholders to discharge the preferred stock's prior claim would be disadvantageous as a business matter, and hence the Commission properly found the plan beneficial to the common.

B. OTHER ALLEGED DISADVANTAGES TO THE COMMON FROM THE LIQUIDATION OF ENGINEERS

The alleged advantages of diversification and centralized management involve nothing more

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[13] A very different aspect of valuing "leverage" was presented by the United Light and Power plan in the *Otis* case, where there were large arrears on the preferred and no present asset value for the common. The charter right of the common to hang on in the hope of future earnings catching up with arrears was found by the Commission to be worth something, although concededly difficult to value. But there, unlike the situation presented by the Engineers plan, the common stockholders had nothing to risk by hanging on, since they were already far below zero on the basis of asset valuation.

than a repetition of arguments fully considered and rejected by the Congress in passing the Act. See e. g. S. Rep. 621, pp. 32–34 (Appendix B to our main brief, p. 140). Here the common stockholders actually acquired through the plan the same diversification they had prior to the plan to the extent that they exercised the Gulf purchase warrants, and could have obtained a similar diversification without any new investment of cash by selling enough of the Virginia and El Paso stock to make a proportionate investment in Gulf.[14] Again, if the independent managements of the operating companies should conclude that there is enough to be gained by pooling certain of their servicing requirements they are free under the Act to organize a mutual service company. See Section 13. Moreover, the argument of Central-Illinois as to loss of economies from centralized management is similar to the argument which the Commission had rejected in the Section 11 (b) (1) case, a ruling which Engineers had not contested in its proceeding to re-

[14] Central-Illinois also refers to the lost diversification incident to divestments which preceded the plan. Apart from the fact that the prior divestments were relatively unimportant as compared to the subsidiaries remaining at the time of the plan, emphasis upon such prior divestments involves the fallacy of either weighing colloquial equities or attempting to reconstitute Engineers' balance sheet as if the Act had never been passed and shifting the incidence of loss in prior transactions contrary to the rule of strict priority. See our main brief pp. 22–28 and 67–69.

view the 11 (b) (1) order and which it made no attempt to retry in the plan hearings.[15]

The argument that liquidation deprived Engineers common stockholders of the tax benefits of filing consolidated returns is either sheer fantasy or requires speculation as to future tax laws. As of the time of the plan it was testified that there was no tax advantage from filing consolidated returns commensurate with the cost of keeping Engineers alive though, of course, if Engineers were kept alive it was deemed advantageous to consolidate (R. 611–624, 833–837). Under existing tax laws filing separate returns for Engineers and its subsidiaries would have resulted in an effective tax of 5.7% of the intercorporate dividends (tax rate of 38% after allowing an 85% credit for dividends). Under the presumably more favorable alternative of consolida-

[15] In the Section 11 (b) (1) proceeding, review of which was mooted by the plan, Engineers failed to satisfy the Commission that there would be a loss of "substantial economies" within the meaning of Section 11 (b) (1) (A) through failure to retain a holding company over the alternative combinations of Virginia with Savannah Electric and Power or Gulf with El Paso (the latter finding being merely advisory since Virginia's electric properties were listed as the "single system"). It would seem to follow *a fortiori* that there would be no loss of substantial economies in the separation of the more widely separated combination of the two largest subsidiaries, Virginia and Gulf. No evidence was taken on that issue, however, since the non-retainability of that combination rested on the Commission's interpretation that clause B of Section 11 (b) (1) required the single and additional systems to be in the same geographic area.

tion, the tax on intercorporate dividends does not apply but 2% of the consolidated income is payable for the privilege of consolidation. On the basis of the earnings of $10,629,724 reported by Virginia, El Paso, and Gulf States for the twelve months ending June 30, 1947, which Central-Illinois assumes *arguendo* constitute prospective "normal earnings," there would be an annual tax saving alone of $212,594 to the common stockholders which would accrue through the dissolution of Engineers.

Under wartime excess profits taxes much larger savings were attributable to consolidation, largely as a result of utilizing the higher invested capital base of the holding company. Central Illinois suggests that such taxes may be restored. We offer no prediction, but in any event this was a possibility not in contemplation when the Engineers plan was consummated.[16] Moreover, we deem it highly questionable whether the Commis-

[16] It was proposed to retain this benefit, at least in part, under the plan originally filed with the Commission which contemplated the possibility of merging Engineers with Virginia. After the repeal of the excess profits tax this feature was eliminated because the tax advantage appeared to have disappeared, and because it was thought that elimination of the merger alternative would remove a possible legal advantage to the preferred stockkholders in arguing against the management's proposal to limit them to their involuntary liquidation preferences. See our main brief, p. 78, n. 46. If it should turn out that the common stock management outsmarted itself in this litigation strategy, we fail to see how the Commission could fairly visit the consequences upon the preferred.

sion could properly assume as a long term matter that Congress would offer a tax bonus to keep alive the holding companies which it is the policy of Setion 11 of the Holding Company act to eliminate.[17]

II. REPLY TO THE ARGUMENT THAT THE COMMISSION'S APPRAISAL OF THE "INVESTMENT VALUE" OF THE PREFERRED STOCKS WAS DEFECTIVE BECAUSE BASED UPON "TRANSIENT MARKET VALUES"

We have shown in our main brief (pp. 7-8; 35-42) that both preferred stockholder and company witnesses testified that on a going-concern basis a willing seller and a willing buyer would value Engineers preferred stocks at slightly in excess of the redemption price and that Engineers' president conceded that such a valuation fully reflected the risk factor as the "investing public is presently appraising these hazards" (R. 525a). We have also shown (pp. 36-37) that

[17] The National Power Policy Committee concluded its recommendations with the suggestion that simplification of holding companies should be stimulated by partial removal of the then exemption under the Revenue Act for dividends received by corporate holding companies and affiliates on the securities of public utility companies and other holding companies. See Senate Report 621, 74th Congress, 1st Sess., p. 60. The Senate Interstate Commerce Committee also recommended the granting of tax exemptions to facilitate voluntary compliance with Section 11 but did not attempt to include such provisions in the Act itself. See S. Rep. No. 621, p. 14. See our main brief, Appendix B, p. 133. Subsequently, the Congress adopted Supplement R of the Internal Revenue Code specifically designed to relieve against realization of capital gains through reorganizations to comply with Section 11.

since the possibility of change in interest rates or other factors affecting the general level of security values would apply to any new investment which preferred stockholders might make with the cash received under the plan, the only fair basis for compensating them for the compulsory surrender of their investment was in accordance with the then cash value of the interest surrendered. The risk factor as appraised by the valuation witnesses and the Commission took into account both the risk that the preferred stockholders might not receive their full preferential dividends and the uncertainty as to the future cost of money.[18] The Badger testimony, which was accepted by the district court, appraised the risk factor on a basis which, apart from the redemption price ceilings, accorded the preferred stocks values substantially above the redemption prices. The Commission, from its own analysis of the investment quality of the preferred, found values on a going-concern basis at least equal to the redemption prices. Granted that the Commission, because it has the statutory responsibility for making its own valua-

[18] Barnes in conceding that a willing seller and a willing buyer would value the preferred at slightly above the redemption prices did not claim that the investing public collectively was wrong in its current appraisal of the risk factor as applied to similar investments. He merely pointed out, what was implicit in the recognition that there was a risk factor, that in the event of unfavorable future developments the preferred stocks might at some future time, if continued outstanding, be worth less than they appeared to be worth then.

tion, might have placed a different appraisal on the risk factor from that made by the valuation witnesses, and might have differed also from the collective judgment of the market place applicable to similar investments, we submit that the Commission's valuation is not to be condemned as irrational merely because it coincided with the judgment of the witnesses and of the general market.[19]

The Commission's appraisal did not, as Central-Illinois argues (p. 81), ignore the historical fact that the securities with which Engineers preferred stocks were compared had sold in times past upon a much higher yield basis, or that current low yields for similar securities were related to government fiscal policies which may have "artificially" lowered interest rates, and which may change. The risk of change in money rates was, as we have seen, simply one of the factors entering into the over-all appraisal of risk. Nor was it of controlling significance that, with the

[19] Central-Illinois points out that the Commission in other cases has consistently rejected the market price of the very securities subject to the reorganization as a test of what constitutes fair and equitable treatment of such securities (pp. 90-91). The obvious reason for this rule is that the market price of the security undergoing reorganization reflects to a substantial degree the market's expectations of the treatment to be accorded such securities in the reorganization. This does not mean, however, that if the market should happen to forecast accurately the kind of treatment which the Commission concludes to be fair then the Commission must necessarily reach a different valuation.

redemption prices tending to fix a ceiling for the preferred, any future change in value could be only in one direction: downward. With the preferred stocks yielding from 5 to 6% as compared to a yield of less than 2% upon relatively risk-free investments such as long-term governments (and yields approaching zero on short-term government securities), the chance of obtaining the relatively favorable return from Engineers preferred stocks up to the date of call at some unpredictable future time, was obviously a factor to be weighed against the risk of lower markets in the future.[20]

Central-Illinois attempts to undermine the district court's acceptance of the Badger valuation testimony by arguing (p. 84) that the district court only accepted his testimony subject to the inherent weaknesses of his method of valuation. But the inherent weakness of the method, as spelled out by Central-Illinois in its brief and as expressed in the district court's findings (drafted by Central-Illinois), involves nothing more than spelling out what is implicit in any attempt to make a valuation of an investment in relation to the risk factor: that there is a risk, or possibility,

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[20] It is not uncommon for bonds and preferred stocks to sell in the markets above a currently applicable call price either because investors are willing to take a chance that the call will not be exercised in the immediate future or even, when its exercise appears relatively certain, because then the senior security approaches the characteristics of a short-term investment.

of adverse developments in the future. The district court did not say that the Badger appraisal of risk (equivalent to a 4.6% capitalization rate applied to the preferred dividends) was too low as an appraisal of the risk. It was merely "found" that because of the element of risk the preferred stocks *might* be worth less in the future. See our main brief, p. 39, n. 25. Thus the inherent weaknesses of the Badger testimony, and of the Commission's appraisal, as emphasized by Central-Illinois, involved merely the inherent limitations of human foresight. The possibility that tomorrow's judgment may be different from today's is no reason why, whoever has the responsibility for the valuation, should not make as fair a current appraisal as is humanly possible.[21]

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[21] We show in our main brief (p. 42, n. 27) that there is no basis for concluding that changes in the cost of money since the Commission's decision would in themselves warrant according the preferred stockholders less than the liquidation preferences and that any changes since the date of consummation are irrelevant. Central-Illinois makes the ambiguous observation (p. 81, n. 2) that equity speaks as of the time of the decree. If this means that up to the time the preferred stockholders were compelled to part with their investment there would be warrant for reexamining the Commission's valuation in the light of more recent developments, we agree. If it means that developments thereafter are to be taken into account, Central-Illinois' theory would deprive the preferred stockholders of the dividend on their investment while leaving them still subject to the risk of being stockholders in the enterprise.

III. REPLY TO THE ARGUMENT THAT THE INVOLUNTARY LIQUIDATION PREFERENCES OF THE PREFERRED ARE DISPOSITIVE

Petitioner's arguments that the involuntary liquidation preferences are the controlling measure of the amount payable to the preferred largely involve a reargument of the *Otis* case. As we show in our main brief (pp. 47–53), the *Otis* case upheld the Commission in "giving value to the rights of the preferred [of United Light and Power] in a going concern rather than as if by sale and distribution." Central-Illinois argues (1) that as a matter of interpretation of Engineers' charter the liquidation preference is controlling; (2) that application of the Commission's rationale to debt might result in a cash payment of less than the face value of the debt while still according a participation to junior interests; (3) that giving value to the rights of the preferred in a going concern, despite the liquidation of the corporate entity, involves "indulging in the baldest fiction" (p. 63), and (4) that valuing the preferred on a going-concern basis was inconsistent with earlier Commission precedents, notably *New York Trust* v. *S. E. C.*, 131 F. 2d 274 (C. A. 2), certiorari denied, 318 U. S. 786, rehearing denied after the *Otis* case, 319 U. S. 781. While the argument as to inconsistency seems to us to prove at most that the *Otis* case may have rejected some of the reasoning of earlier decisions made in different contexts, Central-Illinois' at-

tempt to convey the impression that the Commission's decision in the instant case was a novel departure from the principles of the *Otis* case itself amounts to arguing that the principle of the *Otis* case is a one-way street, applicable only where it is advantageous to common stockholders to accord preferred stockholders a going-concern value amounting to less than the liquidation preferences, but inapplicable where those going-concern values are worth more than the involuntary liquidation preferences. In addition, the effort is made to distinguish the *Otis* case on the ground (1) that this, unlike Otis, is an "authentic" liquidation, and (2) that here the preferred stockholders are to be paid in cash. The first of these alleged distinctions largely involves the fallacious economic assumption discussed *supra* pp. 4, *et seq.* that value disappeared in the liquidation of Engineers. The second involves the anomalous contention that where the common stockholders, through their control of the management, elect to pay senior securities off in cash, the measure of what is surrendered, for the purpose of equating it with the cash received, is different from the measure of the interests surrendered where the method of compensation is through an allocation of securities.

A. ARGUMENTS BASED UPON THE CONSTRUCTION OF ENGINEERS' CHARTER

Central-Illinois argues (p. 24) that what is taking place is clearly a "liquidation, dissolution, or wind-

ing-up of this corporation," and that since the liquidation is taken in view of the compulsion of Section 11 it is not voluntary and therefore is necessarily covered by the charter provisions applicable to liquidations which are not "voluntary". This argument closely parallels the reasoning of the vigorous dissenting opinions of Commissioner Healy and of Chief Justice Stone in the *Otis* case. It was rejected by the majority of the Commission and of this Court in the Otis case, in view of their conclusions that the charter was not adopted in contemplation of the reorganization provisions of Section 11. It was also concluded that the Congress in requiring the simplification of holding company systems, including the liquidation of uneconomic holding companies, did not intend to permit the reorganization to destroy legitimate investment values by causing a shift in the relative rights of the various classes of security holders in the going concern. Maturing the liquidation preferences of solvent companies would, of course, result in such a shift of values. As the opinion of this Court states (323 U. S. 638):

> * * * Where pre-existing contract provisions exist which produce results at variance with a legislative policy which was not foreseeable at the time the contract was made, they cannot be permitted to operate * * *.

The Engineers charter was adopted in 1925 (four years earlier than the United Light and

Power charter involved in the *Otis* case), yet Central-Illinois argues (pp. 42–43) that because of the then current agitation concerning the "power trusts" the security holders are to be taken as having contemplated the adoption, some ten years later, of the reorganization provisions of Section 11. A significant answer to this argument is the statement of William E. Tucker, counsel for Engineers and a draftsman of the charter. This statement, made in an earlier proceeding when it appeared that application of the *Otis* test might place a going-concern value on the preferred of less than $100 a share, was that a Section 11 type of liquidation was not contemplated at the time of the drafting of the charter. See R. 256 (a), 1211 (a), 1731 (a).[22]

B. ALLEGED INCONSISTENCY OF THE COMMISSION

1. *The Federal Water case*

Central Illinois' argument that consistency with the Commission's holdings in other cases required the Commission to treat Engineers' involuntary liquidation preference as the sole measure of the preferred stockholders' claim is largely an argument made and rejected in the *Otis* case itself. Central Illinois notes (p. 50, n. 1) that "the Commission itself early recognized that the distinction between 'liquidation' of the enterprise * * * and a mere alteration in the senior security hold-

[22] See *Streeter* brief, p. 96.

ers' investment in a continuing enterprise", referring to the allocation aspects of *Federal Water Service Corp., et al.*, 8 S. E. C. 893, 907–912 (decided March 24, 1941). This case involved what was in substance a recapitalization, substituting a single class of common stock for the previously outstanding stocks of Federal Water Service Corp., and took the form of a merger with a wholly-owned subsidiary. It contains the first rationalization of the approach followed by the Commission in the *Otis* case, as well as of the contrary views of Commissioner Healy. The majority opinion did contain a dictum, squarely rejected in the *Otis* case, that if Section 11 had required liquidation of the holding company, as distinguished from a simplification of its corporate structure, then, as in bankruptcy, the Commission should treat the liquidation preference as matured by the Act. The fact is, however, that this dictum was rejected both by the Commission and this court in the *Otis* case.

2. *The New York Trust case and the theory of frustration*

Central Illinois' major example of alleged inconsistency on the Commission's part is its decision in the *United Light and Power* debt retirement case (10 S. E. C. 1215), decided February 25, 1942, affirmed *sub nom. New York Trust Co.* v. *S. E. C.*, 131 F. 2d 274 (C. A. 2), or slightly more than two years prior to the later *United Light*

and Power decision upheld by this Court in the *Otis* case. As in its brief in opposition, Central Illinois distorts the problem which this debt retirement presented to the Commission in an effort to convey the impression that application of the approach followed by the Commission in the instant case would have resulted in payments to United Light's bondholders in excess of face amount. Central Illinois refers (p. 54) to "interest rates of 6% and 6½%, rates so lucrative that the debentures had been selling at a premium above par." The footnote upon which Central Illinois bases this statement clearly indicates that the premium of a maximum of 1½ points above par, which was being paid shortly prior to the Commission's decision, after the necessity for the liquidation of Power had been established by a prior unchallenged order and when there was a claim to a 9-point premium at stake in the proceeding, was attributable to the pendency of the plan and was not a measure of the going-concern value of the debentures. The footnote reads as follows (10 Sec. 1227, n. 27):

> All the debentures were originally sold to the public during the years 1923 to 1925 at prices ranging between 90 and 95. From 1931 to 1940 market quotations were constantly below par reaching as low as 25 for a time in 1933. Since 1940 and especially since our order of March 20, 1941, for the liquidation and dissolution of

> Power, market quotations have been close to and sometimes as much as $1\frac{1}{2}$ points above par.

Central-Illinois quotes frequently, and extensively, from the brief of the Commission in *New York Trust Company* v. *S. E. C.*, in which the Commission's decision was rationalized in terms of the legal theory of frustration, but neglects to refer to an alternative point in the Commission's argument that "there is, however, ample indication in the record that the debenture holders have not suffered any loss of investment value, but have indeed been benefited by the liquidation proceedings and the proposed retirement of the debentures as an incident thereto." This argument was premised upon a concession on the part of the New York Trust Company, indenture trustee, that the 9% redemption premium was claimed "because 'there is not in the record a factual basis for any other measure' (Pet. Br. 33)", and was followed by an argument based upon indicia in the record that the debenture holders had a position of substantial risk. (Commission brief in C. A. 2, pp. 30–33).

It may be conceded that the reasoning of the Commission in the *New York Trust* case has not been precisely followed thereafter. That was a unanimous decision despite the cleavage in point of view between Commissioner Healy and the other Commissioners which had already developed, as indicated by the dissent in the *Federal Water*

case—and both Commisioner Healy and the majority were able to cite the case thereafter as upholding their respective positions. See the subsequent *United Light and Power* allocation case, 13 S. E. C. 1, 9, n. 15, and for the dissenting view, p. 28.[23] Cases subsequent to the *United Light and Power* debt retirement case, in which debt claims have been retired at their face value or preferred stocks have been paid off at amounts equal to their involuntary liquidation preferences, have expressly rested on an analysis of the investment position of the security being retired and a finding that face amount or involuntary liquidating preference amounts to full compensation for that going concern value.[24] If, as Central-Illinois

[23] As we note in our main brief (p. 82, n. 50), the alleged inconsistency of the earlier decision, and of the decision of the Second Circuit affirming the Commission in *New York Trust Company* v. *S. E. C.* was fully dealt with in the Government's brief in the *Otis* case and it was then recognized that the Commission's approach might result in appropriate cases in payments in excess of liquidation preferences.

[24] See the cases cited in our main brief, pp. 80–81. That this approach had developed even prior to the *Otis* case is illustrated by the statement in the Government's brief in that case (pp. 52–53) that in decisions since the *New York Trust* case approving prepayment of debt without a premium the Commission predicated its decision upon "an appraisal taking into account interest rate, maturity date, and risk factor incident to the particular debt security," citing (in n. 37) the following: "*North Continent Utilities Corporation*, Holding Company Act Release No. 4686, p. 12 (November 18, 1943), plan enforced in *In re North Continent Utilities Corporation*, 54 F. Supp. 527 (D. Del. 1944) (emphasizing meager

asserts (p. 64, n. 1), arguments made by the senior security holders in the cases subsequent to United Light and Power for realization of going concern values in excess of liquidation preferences, those contentions were rejected, not as irrelevant, but as unsubstantiated on the facts. This view of Commission precedents was recognized by the district court (R. 288a, 292a). In fact, contrary to the statement in Central Illinois brief (p. 17), the district court did not conclude on the basis of the cases denying premiums that the Commission's approach here "contravened firmly rooted decisions of at least four circuit courts of appeals and many district courts, as well as a long line of decisions of the Commission itself." [25]

The doctrine, upon which Central Illinois places so much emphasis (pp. 55, 66, 122), that frustration by operation of law excuses performance in accordance with the letter of a contract, appears to us to be helpful, only to a limited extent, in arriving at a fair and equitable solution of problems under Section 11 (e). The doctrine is rele-

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earnings coverage, unfavorable market history and doubts as to ability to meet maturity five years hence); *Consolidated Electric and Gas Company*, Holding Company Act Release No. 4900, pp. 4–7 (February 21, 1944), plan enforced in *In re Consolidated Electric and Gas Company*, 55 F. Supp. 211 (D. Del. 1944)."

[25] As Central Illinois points out (p. 17, n. 2), the district judge in upholding prior Commission determinations that premiums were not payable had expressly envisaged a contrary result upon proof of "a different fact situation." See *In re North Continent Utilities Corp.*, 54 F. Supp. 527.

vant in showing that junior security holders should not be required to compensate senior security holders, or vice versa for the "disappointed expectation" of not receiving the letter of their contract rights, where to do so would make the process of compliance with the statute result in a windfall to one class of security holders at the expense of another. Thus, the Commission supports the common stockholders and disagrees with the argument in the Streeter brief (pp. 147-154) concerning the alleged unfairness of terminating the preferred stockholders' dividend claims upon a payment (or tender) of $100 on account of their claims while leaving to future litigation the determination as to whether anything in excess of $100 a share might be held fair and equitable.[26]

[26] The Streeter argument as advanced in support of motions for a stay and pressed to a more limited extent in the brief in this Court is that the preferred stockholders were entitled to retain their investment and to continue to accrue preferential dividends at the full charter rate, although concededly in excess of what was fair compensation for the risk, pending a definitive determination by Commission and Court as to the amount of the preferred stockholders' claim. Acceptance of this view would have involved either compelling the company to delay any efforts to secure the cash necessary to retire the preferred, or to keep idle cash equal to the entire amount of the preferred stockholders' claim pending resolution of the dispute. We believe that the same logic which relieves the preferred stockholders of the literal application of the liquidation preference, relieves the common stockholders of the literal application of the preferred stockholders' dividend preference which, by the charter, continues applicable until preferred stockholders acquire the full amount necessary to discharge their claim.

But the doctrine of frustration furnishes no automatic formula for determining what is an appropriate substitute in all cases for strict performance of the letter of the contract. The formula of rescission advanced by Central Illinois would, in a case like *Otis*, require the wiping out of a common stock which has a legitimate expectation of participating in future earnings where present assets are insufficient to restore what was paid in by the preferred. In the present case it would take from preferred stockholders the excess of their going concern value over the amount paid in. Moreover, the analogy purports to be derived from the way in which the law of contracts deals with contracts which are wholly executory. The charter of Engineers can hardly be regarded as an executory contract as of the time of the plan since the preferred stockholders have had their investment subject to the risk of the enterprise for over twenty years.

C. THE ARGUMENT THAT APPLICATION OF THE COMMISSION'S RATIONALE MIGHT RESULT IN A PAYMENT TO A DEBT HOLDER OF LESS THAN FACE AMOUNT

The Commission has never had occasion to deal with the problem posed by Central Illinois of compensating in cash long-term debt carrying an interest rate lower than the current cost of money. The converse situation typically results from the fact that most of the outstanding holding company debts were issued at a time when invest-

ment yields were much higher than today. Moreover, Central Illinois' illustratic of cutting down the bond holder in proportion to the extent that the interest rate might be below the yield on comparable securities, entirely ignores the factor of the date of maturity of the debt. Insofar as the illustration poses the possibility that the interest rate would be low by reason of the risk factor, it may be noted that cash is not likely to be available to discharge a bond not secured to a substantial degree.

A corporate bond, of course, has two aspects. During its life it is an investment contract. At maturity it becomes a claim to a fixed amount of money, to wit, its face amount. During its life a valuation of such a bond must turn upon an appraisal of its investment characteristics; and preeminent among these, of course, is the fact that it will ripen into a mature debt. Therefore, whether or not the conception of a bond as a debt equal to its face amount, as distinguished from an investment contract with a number of features, may influence the Commission's thinking when it is actually confronted with the case Central Illinois poses, we do not venture to predict.[27] Conceiv-

[27] *Georgia Power & Light Company*, Holding Company Act Release No. 5568, cited by Central Illinois, page 93, is, as its statement of the case illustrates, a case where the preferred stock having a liquidation preference (including arrears) of $162.25 as of June 30, 1944, received only $150.00 as the "equitable equivalent of the preferred stockholders' rights". Central Illinois argues that this withholding was directly

ably, in dealing with a bond of relatively short maturity, with no unusual characteristics, the Commission might be more inclined to emphasize the debt concept than in dealing with a bond of long term maturity, having an unusually low interest coupon or perhaps having its interest payable only if earned. As Central-Illinois notes, the Commission has dealt with the converse situation in the American Power and Light case, where payments in excess of face amount were accorded to relatively well secured debentures having a remote maturity (See Central-Illinois brief, p. 64). See Holding Company Act Release No. 6176. Any objection to the instant decision of the Commission on the assumption that it forecasts such the result supposed by Central-Illinois and on the further assumption that the result is objectionable would apply, of course, with equal force to the decision in the *Otis* case.

D. THE ARGUMENT THAT IT IS FICTITIOUS TO COMPENSATE THE PREFERREDS FOR THEIR RIGHTS IN ENGINEERS AS A GOING CONCERN

In urging that the Commission indulged in the "baldest fiction" when it valued the preferred on a going concern basis, Central Illinois necessarily

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contrary to the instant case but, so far as we are aware, the only distinction is that in that case the preferred stock, which was in arrears with respect to dividends, was not valued by the Commission on a going concern basis at an amount equal to its liquidation preference, which, of course, was less than its redemption price.

levels the same charge at the decision of this Court in the *Otis* case. Once it is recognized that a liquidation resulting from the impact of the Holding Company Act does not mature the liquidation claims, or limitations, of the securities of the corporation, the argument that the Commission is indulging in a fiction in valuing the rights of Engineers stockholders on a going concern basis is revealed as nothing more than rhetoric. The valuation of the rights surrendered must, as in the *Otis* case, or in any reorganization, necessarily be based on a valuation of the old securities in the enterprise as it was, for those are the rights surrendered.[28] Thus, in a recapitalization it is neces-

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[28] If the plan contemplates a new corporation to carry on the old business, the old securities are valued as if the old corporation continued in existence. If the plan contemplates addition or subtraction of assets the old securities are valued as if the business operations continued with the existing assets. If the plan contemplates liquidation of a holding company and distribution of its assets among existing security holders, whatever weight may be given (by reason of tax savings, for example) to the prospective disappearance of the holding company in valuing the new securities, the old securities are valued as if the holding company continued in existence. On the other hand, the process of valuing the rights surrendered by a plan does take into account, for their impact on prospective earnings, any changes which could be effected, apart from the reorganization itself: for example, the possibility of refunding at a saving in interest or dividend claims, outstanding securities of the company or its subsidiaries not affected by the plan. In some instances the very securities which are dealt with in the plan itself might have been refunded apart from the plan, and in that event this possibility is also relevant to the valuation process.

sary, in determining whether that which is received is the equitable equivalent of the rights surrendered, to value the old security for the purpose of comparing it with the new, according to what it would be worth if there were no recapitalization. Similarly, where a merger occurs the old security must necessarily be valued on the basis of what its prospects would have been if there were no merger for the purpose of comparison with the rights tendered under the merger.[28a] Similarly, in a liquidation required by Section 11, the technique of appraising the rights surrendered by the plan necessarily involves appraising them

[28a] While, as *Schwabacher* v. *United States*, 334 U. S. 182, holds, the federal test is controlling, it should be noted that the state law merger cases relied on by Central-Illinois (p. 36, n. 1) do not support its position; in fact, *Matter of Fulton*, 257 N. Y. 487, 178 N. E. 766, 769, laid down an "investment value" test quite similar to the allegedly novel test of the Commission in this case, stating:

• It will be readily appreciated that the appraisers should have considered the investment value of the stock which is largely determined by the rate of return, the security afforded that the dividends will be regularly paid, the possibility that dividends will be increased or diminished, the selling price of stocks of like character, the amount of preferred stock in comparison with the common stock, the size of the accumulated surplus applicable to the payment of dividends, the record of the corporation, and its prospects for the future.

American General Corp. v. *Camp*, 190 Atl. 225, 229 (Md.), held that there was no going concern value for the preferred stocks dealt with since "the net earnings of the corporations from dividends and interest were too scant to justify a basis for capitalization."

on a going concern basis, i. e., as if the liquidation or reorganization did not occur.[29]

E. THE EFFORTS TO DISTINGUISH THE *OTIS* CASE

In our main brief (pages 76–79), we deal with Central-Illinois' argument that the *Otis* case applies only where it is a top holding company which is liquidated and where its liquidation leaves a surviving holding company controlling the same operating companies. We there show that this court expressly rejected a rationale which would have limited its decision to such a situation. Central-Illinois makes the further argument that paying the preferred stockholders off in cash makes the present liquidation unlike that in *Otis* an "authentic one." If this distinction is sound, however, it means that the common stockholders have the power, by deciding whether to pay the preferred off in securities or in cash, to give the preferred either the full going concern value of their interest or something less.

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[29] Central-Illinois notes that in an advisory report under Chapter X, the Commission has taken the position that the proper measure of participation for a non-callable 7% preferred stock is not the investment value of the security but its liquidation preference. See matter of *Childs Company* Corporate Reorganization Release No. 67, quoted by Central-Illinois, page 36, n. 2. This position, however, is entirely consistent with the distinction which the Commission made in the *United Light and Power* (Otis) allocation case to the effect that bankruptcy reorganizations, unlike those under Section 11, do result in maturing liquidation preferences. See our main brief, p. 50.

Central-Illinois attempts to escape this obvious weakness of its argument by urging further that payment in cash even at the involuntary liquidation preferences gives the preferred stockholder more than what is fair because it gives him more value than he would get under an allocation plan. This possibility is illustrated by references to instances in which the market value of securities received by bondholders or preferred stockholders under allocation plans were, at the time of distribution, substantially later than the Commission's decision, less than their liquidation preferences (pp. 89–90). Of course, inherent in an allocation plan which offers a security holder a participation in future earnings in exchange for a prior but limited preferential claim is the possibility that the security holder may acquire something the market may at some time appraise at less than his old liquidation preference. But in giving up his preferential position the preferred stockholder under such a plan acquires an opportunity to gain in return for the greater risk.

The Commission never had occasion to determine what percentage of Engineers' assets would be allocable to the preferred stock under an allocation plan for the simple reason that the management, in accordance with its conception of the interests of the common stockholders, desired to retain the assets of the enterprise exclusively for the common stockholders. We believe it obvious,

however, that the Commission, in view of the risk factor, would not have made the absurd allocation suggested by Central-Illinois (page 101). In any event, we fail to see how fairness permits the common stockholders to exclude the preferred stockholders from any participation in future earnings and, at the same time, requires the Commission to burden its cash appraisal with the risk of what they might have lost under an allocation plan. This, like so many aspects of the Central Illinois position, rests upon the wholly untenable premise that the form of the plan and the manner of satisfying the rights to be surrendered thereunder can, in some mystic and fictional manner, affect the value of the rights which are to be surrendered.[30] Once it is recognized, as this Court has so often recognized, that the rights to be surrendered must be valued, by looking at the securities embodying them, as securities in the preexisting enterprise, this like the rest of the attempted distinctions of the *Otis* case falls by its own weight.

IV. REPLY TO CENTRAL-ILLINOIS' ARGUMENTS CONCERNING SCOPE OF REVIEW

We believe that our main brief fully covers Central-Illinois' argument concerning the scope of review except for its suggestion that no prac-

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[30] Thus, it is Central-Illinois which seeks to confuse "the medium of payment with the mode of determining the amount of payment." *Cf.* Central-Illinois brief p. 92.

tical difficulties would result from treating the Commission and the district court as having coordinate valuation functions. Central-Illinois urges that there could not be an enforcement proceeding in a district court after affirmance by a court of appeals. As a matter of fact, the issues which the Commission considered settled by this Court's decision in the second *Chenery* case have actually been reopened in the United States District Court for the District of Delaware in connection with a proceeding to enforce a plan for the liquidation of Federal Water and Gas Corporation. In that proceeding Chenery, et al. argue (1) that the determinations in the prior review proceeding were not a conclusive adjudication of their rights of participation, and (2) that in view of the decision of the Court of Appeals in the *Engineers* case, the district court should exercise an "independent judgment" as to the fairness of the earlier plan. Nor is it true, as Central-Illinois argues (Br. 145), that "the Commission has established the practice [in the case of Section 11 (e) plans cutting across stockholders' charter rights] of expressly conditioning its approval of such plans upon District Court enforcement.[31] The Commission does endeavor to ascertain, prior to its decision, whether enforcement will be requested, to

[31] This is not to say that the Commission would permit dissenters to exercise state law appraisal rights inconsistent with the plan whether or not enforcement is requested. *Cf. Schwabacher* v. *United States*, 334 U. S. 182.

avoid the confusion which would otherwise result in the event of simultaneous challenge to its order in a court of appeals under Section 24 (a) and in a district court in an enforcement proceeding.[32] See our main brief p. 87.

CONCLUSION

We, therefore, believe it clear that the Commission applied proper legal standards to the valuation of the preferred stocks which should not be reduced because of imaginary deprivations which the common stockholders allege they suffered from compliance with Section 11 of the Holding Company Act.

Respectfully submitted.

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[32] *Cf. Application of the Securities and Exchange Commission*, 50 F. Supp. 965 (D. Del.), discussed in our main brief, p. 106, n. 63.

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